No. 10556

IN THE

UNITED STATES CIRCUIT COURT OF APPEALS

FOR THE NINTH CIRCUIT

UNITED NATIONAL CORPORATION, a corporation,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON PETITION FOR REVIEW FROM THE TAX COURT OF THE UNITED STATES

REPLY BRIEF FOR THE PETITIONER

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ARGUMENT

The respondent in his brief makes the statement that, should petitioner prevail in its contention in this cause, then the field would be opened to a means of tax evasion. This statement is wholly without foundation. Where a shareholder receives a distribution upon redemption of his shares, similar to the distribution in issue here, the amount received, if in excess of the cost of his stock, is a capital gain and taxable as such. When a non-taxable distribution is made without the redemption of stock, the stockholder's cost is reduced by the amount of the distribution (see Sec. 115(d) of the Internal Revenue Code). Upon a subsequent sale at a price in excess of cost, he is subject to income tax on the gain. The incidence of the tax is not

avoided, it is merely postponed. So in the case of the petitioner, if it had received more than its cost, upon the redemption of the shares of Murphey Company held by it, the excess would be subject to tax. When the shareholder, upon redemption of his shares, receives less than the cost of his stock, no equitable considerations force the imposition of a tax.

Respondent, at page 9 of his brief, says:

> "This is not a case of a return to preferred stockholders of capital contributed by them, but distribution to a common stockholder of a fund over and above any sum contributed or invested by it."

This is a gratuitous statement not supported by the record. The fact is that the petitioner, upon redemption of its shares, received less than the cost of the shares to it, as respondent well knows.

It is said, in respondent's brief, that "Indeed it is clearly inferable from the conceded findings that Murphey Company repurchased the preferred stock, when and as it did, in order to obtain this gain" (p. 9). No such inference can be drawn. The actual reason for the redemption of the preferred shares is set forth in the findings of fact:

> "* * * During the early 1930's, the business substantially decreased. As a result, all of the preferred stock was retired before and during 1932." (R. 29)

The respondent says that The Tax Court found as a fact that the sum of $20,389 did not form a part of either, "capital paid in for stock or paid in surplus—cash paid in." He might have gone further and stated that The Tax Court found as a fact, the $20,389 was

a part of the earned surplus. The status of the $20,389, as earned surplus or paid in surplus, is not properly a finding of fact. It is a conclusion of law, and, indeed, the ultimate question to be decided in this cause—whether the $20,389 is a part of the earnings or profits. If it is a part of the earnings or profits, it is, of course, earned surplus. If it is not a part of the earnings or profits, it is not earned surplus but paid-in capital. The findings of The Tax Court set forth the stipulation of the parties as to the point involved in this cause (R. 28-29). In view of the stipulation, we do not believe it meet or profitable to go into any extended discussion as to what are findings of fact and what are conclusions of law. The mention of this point by respondent merely confuses the issue and the record. Petitioner has obeyed the mandate of the Rules of Civil Procedure to bring up only so much of the record as to show clearly the point involved. The point can and should be decided without reference to technicalities of the record.

The respondent states that the average man would readily agree that an actual profit was realized. He then goes on to state that:

> "At the moment that the last share of the preferred stock was retired, and the capital of the company, which the preferred stock represented, was reduced by its cancellation, the amount of $20,389 became the property of Murphey Company for the benefit of its sole common stockholders, the taxpayer, subject to no liabilities of any kind." (pp. 9-10)

The Murphey Company realized no profit when it redeemed the shares of its preferred stock. It got

nothing. Indeed, it actually had less assets after the redemption than before. It is entirely conceivable that the Murphey Company had assets of less worth than the par value of its shares remaining after the redemption of its preferred stock. The fallacy in respondent's reasoning is that he assumes that par value represents actual value, and that the outstanding preferred shares represented a debt owing by Murphey Company.

Petitioner's position is clear cut and in accord with sound principles. It is simply this: when Murphey Company redeemed its capital stock for less than its par value, the difference between par and the amount paid was properly credited to capital surplus. When such capital surplus is distributed, the shareholders charge the amount of the distribution received against the cost of their shares. If in excess of the cost of their shares, the balance is taxable as a capital gain. The earnings or profits of the corporation are not affected by the redemption of its own shares. As pointed out, no principle of tax avoidance is involved. If the shareholder, upon redemption of his shares, received more than he paid for them, he is taxed on the gain.

THE CASES CITED BY RESPONDENT

Respondent cites a statement from *Cummings v. Commissioner* (C.C.A. 1) 73 F.(2d) 477, in support of his argument. The statement is as follows:

> "If these funds, however derived, belonged to the Company when received, they would go to increase its surplus, and it cannot be seriously argued that the *surplus funds in the hands of the company over and above its stock liability are not the earnings or profits contemplated by the section.*"

That part of the statement in italics is ill-considered and not necessary to the decision. An analysis of the statement will show that, standing by itself, it is wholly inaccurate. Paid in surplus, surplus arising from the reduction of capital stock, and amounts paid in on capital stock subscription contracts and forfeited to the corporation, all give rise to surplus funds in the hands of the corporation over and above its stock liability. Yet in none of such cases do the funds represent earnings or profits of the corporation.

The respondent contends that in *Morainville v. Commissioner*, 46 B.T.A. 753, the Board of Tax Appeals sustained the Commissioner's contention on facts closely similar to those at bar. An examination of the case will reveal that it was actually decided on the ground that the petitioner failed to prove that the earnings or profits were insufficient to pay the dividends. The following quotation from the decision makes that clear:

> "but the analysis (of surplus) is too superficial to make it clear that these adjustments prove that the earnings and profits are less than enough

> to support the 1936 and 1937 dividends of series 'B' shares."

Moreover, the quotation from the decision cited in respondent's brief makes it clear that the basis of the decision was not what respondent contends that it was: "It is entirely possible that the amount is within earnings and profits from which taxable dividends may be distributed." This language itself shows that the statement was *obiter dictum.*

In his discussion of *Weingarten v. Commissioner*, 44 B.T.A. 798, respondent makes the statement that the $30.00 premium over par value paid by Murphey Company in one transaction where preferred stock was redeemed, was "undoubtedly charged to earnings or profits." This is a violent assumption particularly in view of the sworn statement in petitioner's petition below that "the debit or credit (arising from the redemption of preferred stock) was charged or credited to capital surplus on the books of Murphey, Favre & Company" (R. 9). The holding in the *Weingarten* case has nothing to do with the point at issue here. In that case, the corporation actually paid out a certain sum in excess of par value to shareholders. The sum so paid out would necessarily come out of earnings or profits as the distribution is considered in the nature of a dividend to the extent that the distribution exceeds par value. Here the Murphey Company, upon redemption of its shares of preferred stock, received nothing. It does not necessarily or at all follow, that, because a charge against earnings or profits is sustained where a premium is paid for preferred stock purchased and cancelled, that a corre-

sponding credit to earnings or profits results when the stock is purchased at a discount and cancelled. The two situations are entirely different.

Golden State T. and R. Corp. v. Commissioner (C.C.A. 9) 125 F.(2d) 641, has no bearing on the case at bar. There was no redemption of shares involved in that case. There was a dividend distributed by a subsidiary corporation out of its earnings. The distribution was represented by shares of the parent corporation's stock. The decision was right on the facts. The quotation from the case set forth in respondent's brief must be read in the light of the facts there involved.

CONCLUSION

It is submitted that The Tax Court of the United States was in error in holding that the earnings or profits of Murphey were increased by the repurchase of its preferred shares at less than their par value.

Respectfully submitted,

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Attorneys for Petitioner.